No. 15434

In the

United States Court of Appeals

For the Ninth Circuit

AH PAH REDWOOD CO., A California Corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPELLANT'S BRIEF

Petition to Review a Decision of the
Tax Court of the United States

HONORABLE ERNEST H. VAN FOSSAN, Judge

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JURISDICTION

Appellant Ah Pah Redwood Co. is a corporation organized and existing under and by virtue of the laws of the State of California, with its principal office and place of business located in Portland, Oregon. Respondent determined deficiencies in income tax of appellant, and additions thereto, for the years 1948 and 1949, pursuant to Sec. 291(a) of the Internal Revenue Code of 1939. Appellant filed its petition with the Tax Court of the United States, and being aggrieved by the adverse decision rendered therein on October 28, 1956 (R 28),

filed its Petition for Review (R 29) with that Court on December 18, 1956.

Jurisdiction of this Court is based upon Title 26 US Code, Sec. 7481-7483.

STATEMENT OF THE CASE

Appellant, upon its organization in October, 1947, purchased all right, title and interest of "the buyer" in timber and lands covered by a certain purchase agreement (R 17). The agreement, dated December 13, 1946, defines Sage Land and Lumber Co., Inc. as "the seller," and Union Bond & Trust Co. as "the buyer." The timber and land are located in Humboldt County, California. The purchase price paid by appellant to "the buyer" was $1,443,838.99. Hereafter this timber will be referred to as the Sage timber (Ex. 1-A; R 57).

Shortly after the Sage timber was acquired, appellant entered into an oral or implied agreement with Coast Redwood Co. (hereafter referred to as Coast), whereby the latter was permitted to enter upon the property to cut timber, and agreed to pay for such timber at the rate of $5.00 per thousand board feet as removed (R 18).

On January 9, 1950, appellant executed a formal written agreement with Coast, pursuant to which ap-

pellant sold all the then remaining Sage timber to Coast (Exhibit 2-B, R 72).

In the years 1948 and 1949, appellant reported profits on sales of timber to Coast as long-term capital gains (R 18). In so reporting this income, petitioner used a basis for depletion of $3.941566 per thousand board feet (R 18). Respondent also used such basis in computing a portion of the deficiencies here in question. Both parties computed the basis for depletion by dividing the amount of timber on the Sage Tract, as shown on Schedule A of the Sage Agreement per the French cruise (Ex. 1-A, R 57), which amount appellant assumed to be the correct quantity thereof, into the total purchase price paid by appellant for such timber (R 18). In 1952, appellant first realized that Schedule A of the Sage Agreement erroneously overstated the quantity of timber on the Sage Tract by a substantial amount. When appellant made an actual cruise shortly after logging operations ceased in November of 1954, the overstatement was found to be approximately double the actual amount of timber on the property, or a "fall-down" of approximately 48 per cent (R 19).

In addition to other sales, appellant sold 33,883,000 board feet of timber covered by the Sage Agreement to A. K. Wilson Lumber Co. in 1950. This quantity of timber was assumed to be the above amount on the

basis of the quantities shown in Schedule A to the Sage Agreement. Prior to appellant's acquisition of the Sage Agreement, International Pacific Pulp & Paper Co. sold 16,022,060 board feet of the timber covered thereby to Coast in the years 1946 and 1947 (R 19).

On June 18, 1953, respondent issued its 90 day letter to appellant, listing deficiencies in the following amounts:

Year	*Deficiency*	*Addition to Tax*
1948	$ 2,654.84	$ 663.71
1949	35,649.37	8,912.35

Respondent's deficiencies are based upon the theory that amounts received by appellant from Coast for timber cut and removed by Coast during the years in question were ordinary income rather than long term capital gain, since the oral or implied agreement of the fall of 1947 constituted a "disposal" of the timber under the provisions of 1939 IRC Sec. 117 (k) (2).

Appellant duly filed its petition with the Tax Court of the United States on September 16, 1953, protesting the deficiencies issued by the Commissioner (R 3). In that petition, appellant also sought adjustment of its basis for depletion allowance for the years in question because of the "underrun" of approximately 48 per cent of the timber originally estimated to be upon the Sage Tract.

On May 9 and 10, 1955, trial was had before the Tax Court of the United States, and on September 28, 1956, the Tax Court filed its opinion (R 16-28). A decision was entered on Sunday, October 28, 1956 (R 28), and on Monday, October 29, 1956, appellant filed a Motion for Revision with the Tax Court of the United States (R 76). No action having been taken thereon, on December 18, 1956, appellant filed with the Tax Court its Petition for Review of the case by this tribunal (R 29).

SPECIFICATIONS OF ERROR

I. The Tax Court erred in its finding that amounts received by appellant in 1948 and 1949 from Coast for timber cut from the property of appellant are taxable as ordinary income.

A. The record does not permit a finding that appellant was engaged in the trade or business of selling timber or that the timber in controversy was held primarily for sale to customers in the ordinary course thereof.

B. The law (1939 IRC §117(j)) and regulations in effect during 1948 and 1949 require that appellant treat the amounts received as long term capital gains.

C. The oral contract between appellant and Coast was not a "disposal" of timber on the date thereof under the then existing laws and regulations.

II. The Tax Court erred in its determination that appellant's depletion allowance for the taxable years 1948 and 1949 is not adjustable to correctly reflect the units of timber standing on appellant's property during those years.

A. The depletion allowance for 1948 and 1949 is adjustable because of gross error, misrepresentation or fraud.

ARGUMENT

I.

THE TAX COURT ERRED IN ITS FINDING THAT AMOUNTS RECEIVED BY APPELLANT IN 1948 AND 1949 FROM COAST FOR TIMBER CUT FROM THE PROPERTY OF APPELLANT ARE TAXABLE AS ORDINARY INCOME.

A. The record does not permit a finding that appellant was engaged in the trade or business of selling timber, or that the timber in controversy was held primarily for sale to customers in the ordinary course thereof.

The record of this case shows nothing relating to the trade or business of appellant. The only business

transactions referred to are those dealing with the Sage timber. The nature of appellant's business has never been raised by the Commissioner.

Although a presumption arises in the Tax Court in favor of action taken by the Commissioner in assessing taxes, such a presumption does not and cannot arise with respect to contentions never raised by the Commissioner at any time prior to or during trial.

The presumption of correctness of the Commissioner's determination does not apply where he abandons the theory of his deficiency notice and seeks an increased deficiency on a different ground. *Seaside Improvement Co. v. Commissioner*, 105 F. 2d 990 (2d Circ, 1939); *Sheldon Tauber*, 24 TC 179 (1955).

Where the Commissioner changes the theory upon which he bases the deficiency subsequent to issuing the assessment notice, there is no presumption in favor of the Commissioner, and he must carry the burden of proof. *George B. Markle*, 17 TC 1593 (1952.

In *Weaver v. Henslee*, 120 F. Supp. 707, at page 710 (USDC, MD, Tenn., 1954), the Court said:

> "Property is not held for sale to customers unless the taxpayer has customers and holds the property for the purpose of selling it to those customers rather than for some other purpose, such as to receive income from the property, or for a rise in the mar-

ket value of the property or for use in his own business. *Houston Deepwater Land Co. v. Scofield*, D.C., 110 F. Supp. 394; *Williamson v. Bowers*, D.C.S.C., 120 F. Supp. 704; Kemon, 16 TC 1026; *Latimer-Looney Chevrolet, Inc.*, 19 TC 120."

Conclusions of law cannot be based upon findings of fact not supported by the evidence. 3 Am. Jur. 463 (Appeal & Error, § 899).

In *Estate of Tarrant*, 38 Cal. 2d 42, 237 P. 2d 505, at page 509, 28 ALR 2d 419 (1951), the Court, in speaking of findings made by the trial court, said:

"* * * While it is true that 'the findings of the trial court will not be disturbed on appeal if the record discloses substantial evidence to support them', as was the case in *California Employment Commission v. Betthesda Foundation*, 54 Cal. App. 2d 348, 350, 129 P. 2d 874, 876, where the issue involved was the charitable status of the corporation in question, such rule has no pertinency where the evidence without conflict clearly establishes the impropriety of the inferences drawn by the court from the uncontroverted facts."

In *Joseph Milling Co. v. First Bank of Joseph*, 109 Or. 1, at page 7, 216 Pac. 560, 29 ALR 358 (1923), the court said:

"Of course, if the record is devoid of any evidence to support an essential fact, a judgment can-

not be permitted to stand (*Tillamook County Bank v. International Lumber Co.*, 106 Or. 339, 211 Pac. 183); * * *"

The law, as set forth in 26 USCA § 7453[1], and Tax Court Rule 31 (a)[2], provides that the rules of evidence applicable to trials without a jury in the United States District Court for the District of Columbia shall apply to proceedings before the Tax Court of the United States.

The Tax Court may not make a finding of fact, and rest thereon a conclusion of law, when no evidence to support that fact is in the record.

Rule 52 (a) of the Federal Rules of Civil Procedure[3] applies to cases tried before the Tax Court. *Commissioner of Internal Revenue v. Brown Shoe Co.*, 175 F. 2d 305 (8th Circ., 1949) reversed on other grounds, 339 US 583, 94 L. Ed 1081, 70 S. Ct. 820 (1950).

Findings of fact not substantiated by the record are subject to attack on appeal. *Nee v. Main Street Bank*, 174 F. 2d 425 (8th Circ., 1949) cert. den. 338 US 823, 70 S. Ct. 69, 94 L. Ed. 500 (1949); *District of Columbia v. Seven Up Washington*, 214 F. 2d 197 (C.A.D.C., 1954) cert. den. 347 US 989, 98 L. Ed. 1123, 74 S. Ct. 851 (1954).

Numbered Footnotes refer to Appendix.

In 39 Am. Jur. 146 (New Trial § 138), it is said:

"Where a cause has been tried by the court, its decision or finding has the same effect as the verdict of a jury, and if contrary to or not sustained by the evidence, a new trial may be granted. The question to be resolved by the appellate court is whether the trial judge, as a reasonable individual, acting as trier of the facts, could have found from the evidence such a verdict."

To the same effect see *Parsons v. Federal Realty Corp.*, 105 Fla. 105, 143 So. 912, 88 ALR 275 (1931).

In 89 CJS 471 (Trial § 638) it is said:

"In general, the amendment or correction of findings of fact and conclusions of law by the trial court rests in its sound discretion. Hence, while the trial court may properly amend or correct its findings of fact and conclusions of law where the evidence is sufficient to support the amendment made, and should amend them as far as necessary to make them conform to the facts admitted, provided the nonconformity is material, or where they fail to follow the evidence and do not speak the truth to the detriment of the party complaining, *generally speaking, it is required to amend or strike them only when they are not supported by the evidence or are outside the issues litigated.*" (Emphasis supplied)

Here, there is no basis whatever to support a finding regarding the nature of the business engaged in

by appellant. Nothing in the record indicates that appellant was or is engaged primarily in the sale of timber to customers in the ordinary course of its business. The nature of appellant's business and its purpose in holding the timber was never in issue, and no evidence was presented with respect thereto.

The finding of the Tax Court that appellant held the Sage timber primarily for sale to customers in the ordinary course of business is without foundation in the record. Such finding cannot be permitted to stand. Appellant is entitled to reversal of the decision of the Tax Court, insofar as it was based upon such finding.

B. The law (1939 IRC Sec. 117(j)) and regulations in effect during 1948 and 1949 require that appellant treat the amounts received as long-term capital gains.

The statutory language pertaining to the tax treatment of the disposal of timber is clear. 1939 IRC §117 (j) (1) reads in part as follows:

> "*Such term* ('property used in the trade or business') *also includes timber with respect to which subsection (k) (1) or (2) is applicable.*" (Emphasis supplied)

The language of 1939 IRC § 117(j) (1) and § 117 (k) (2) must be interpreted to carry out Congressional

intent. When that intent is determined, it controls the meaning of the statutory language. The best source of knowledge of Congressional intent is found in pronouncements of persons and the responsible agency who had contact with Congress at the time of the enactment of the statute.

The language contained in the regulations promulgated by the Commissioner of Internal Revenue in 1944, shortly after the above statute was enacted, and in effect during 1948 and 1949, is explicit. It sets forth in plain, concise words the intended meaning of the statute.

Reg. 111, § 29.117-7 reads in part as follows:

> "*Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business.* Section 117 (j) provides that the recognized gains and losses
>
> * * * * *
>
> "(c) From timber held for more than six months which is considered to have been sold under the provisions of section 117(k) (2), and with respect to taxable years beginning after December 31, 1943, from timber owned or held under a contract right to cut for more than six months prior to the beginning of the taxable year which is considered to have been sold or exchanged under the provisions of section 117 (k) (1), *regardless of whether such timber would be properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or whether such timber was held by the*

taxpayer primarily for sale to customers in the ordinary course of his trade or business,

"shall be treated as gains and losses from the sale or exchange of capital assets held for more than 6 months if the aggregate of such gains exceeds the aggregate of such losses. If the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets.

* * * * *

"Section 117 (j) does not apply to gains and losses on the sale, exchange, or involuntary conversion of any property which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year or which is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, * * * but not including as such property timber which is considered to have been sold or exchanged as provided in section 117 (k) (1) or which has been sold as provided in section 117 (k) (2) * * *." (Emphasis supplied)

The provisions of 1939 IRC § 117 (k) (2) in effect during the years in question are as follows:

"(2) In the case of the disposal of timber (held for more than six months prior to such disposal) by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber, the difference between the amount received for such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber."

The language of the regulation then in effect is specific. Reg. 111, § 29.117—8 (b) provides as follows:

> "If the taxpayer owned the timber for a period of more than six months prior to the date of such contract, for the purposes of section 117 (j) such timber shall be considered to be property used in the trade or business for the taxable year for which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 117 (j) (1). Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from the sale of a capital asset held for more than six months will depend upon the application of section 117 (j) in the case of the taxpayer."

The language of the statutes and regulations in effect during 1948 and 1949 clearly establishes the rule that timber is to be considered a capital asset used in trade or business, even though it may be held primarily for sale to customers in the ordinary course of trade or business.

The interpretation placed upon the statutes by the regulations issued in 1944 effectively declares and carries out the intent of Congress. Also, see Senate Report No. 627, 78th Congress, December 22, 1943, 1944 CB 993, 1015[4]; House of Representatives Report No. 1079, 78th Congress, February 4, 1944, 1944 CB 1059, 1068[5].

In 1951, Congress amended § 117 (j) (1) and § 117 (k) (2) of the Internal Revenue Code of 1939. However, these amendments did not in any way change the above quoted sections as they apply to timber. As amended, the sections read in part as follows:

> "(j) *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property used in the Trade or Business.*
>
> "(1) *Definition of property used in the trade or business.* * * * Such term ('property used in the trade or business') also includes timber or coal with respect to which subsection (k) (1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable."
>
> "(k) *Gain or Loss in the Case of Timber or Coal.*
>
> * * * * *
>
> "(2) In the case of the disposal of timber or coal (including lignite), held for more than 6 months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber or coal, the difference between the amount received for such timber or coal and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber or coal."

In 1953, the Commissioner of Internal Revenue issued new regulations to implement the statutory amendments of 1951. Although these regulations de-

leted certain references regarding timber held primarily for sale to customers in the ordinary course of business, they still recognized the intent of Congress in the original enactment of these statutes and the correct interpretation of them reflected by the regulations issued by the Commissioner in 1944.

Reg. 111, § 29.117-7, as revised, provides in part as follows:

> "*Gains and Losses from Involuntary Conversions and from the Sale or Exchange of Certain Property used in the Trade or Business.*
>
> (a) *in general*—(1) Section 117 (j) provides that the recognized gains and losses described below shall be treated as gains and losses from the sale or exchange of capital assets held for more than six months if the aggregate of such gains exceeds the aggregate of such losses. If the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets. The gains and losses referred to above are the following:
>
> "(i) Gains and losses from the sale, exchange, or involuntary conversion of 'section 117 (j) property', as defined blow, held for more than six months.
>
> "(ii) Gains and losses from the involuntary conversion of capital assets held for more than six months.
>
> "(iii) Gains and losses upon cutting or disposal of timber, or disposal of coal, to the extent provided in section 29.117-8.

"(iv) Gains and losses from the sale, exchange, or involuntary conversion of livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for more than six months from the date of acquisition (twelve months or more from the date of acquisition in the case of a taxable year beginning after December 31, 1950). (See (c) below.)

"(v) Gains and losses from the sale, exchange, or involuntary conversion in a taxable year beginning after December 31, 1950, of an unharvested crop under the conditions specified in (d) hereof.

* * * * *

"(3) For the purpose of this section, the term 'section 117 (j) property' means property used in the trade or business of the taxpayer at the time of its sale, exchange, or involuntary conversion, which is of a character subject to the allowance for depreciation provided in section 23 (l) or which is real property, except any such property which is within one of the following categories:

"(i) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or which is held by the taxpayer primarily for sale to customers in the ordinary course of trade or business.

"(ii) In the case of taxable years beginning after September 23, 1950, a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in section 117 (a) (1) (C).

"(iii) Livestock held for draft, breeding, or dairy purposes. (See, however, (1) (iv) above.)

"(iv) In the case of a taxable year beginning after December 31, 1950, poultry."

The provisions defining "section 117 (j) property" relate *only* to the term as used in subparagraph (a) (1) (i) of the regulation, and that term is used only in a separate subparagraph from the subparagraph referring to timber. Thus, the subparagraph referring to "section 117 (j) property" has no application to the subparagraph relating to timber. This is borne out by the language of Reg. 111, § 29.117-8 (b), as it pertains to timber, which was unchanged when the revised regulations were issued.

The enactment of the 1954 Revenue Code further clarified the law, as it had always been understood, by placing timber and coal in a separate subsection in defining "property used in trade or business." The general rule regarding property used in trade or business, containing the exceptions regarding inventories and property held primarily for sale to customers, is in a separate subsection of equal standing. It is apparent from this separation, previously accomplished by separate sentences in the same subparagraph, that Congress intended to completely clarify the rule that timber and coal should not be subject to the exceptions applicable to other types of property covered by the general rule in determining what constitutes "property used in trade or business." 26 USCA § 1231 (b) provides as follows:

"*Definition of Property Used in the Trade or Business.*—For purposes of this section—

"(1) *General Rule*—The term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

"(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

"(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

"(C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

"(2) *Timber or Coal.* Such term includes timber and coal with respect to which section 631 applies."

This same clarification is carried out in the proposed regulations issued on July 18, 1956. Proposed Reg. 1.1231-1 provides in part as follows:

"Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The noncapital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 6 months, other than stock in trade and certain copyrights and artistic property; (2) timber and coal, if disposed

of in a manner coming within the provisions of section 631; and (3) certain livestock and unharvested crops. See paragraph (c) of this section.

* * * * *

"(c) *Transactions to which section applies.*

"Section 1231 applies to recognized gains and losses from the following:

"(1) The sale, exchange, or involuntary conversion of property held for more than 6 months and used in the taxpayer's trade or business, which is either real property or is of a character subject to the allowance for depreciation under Section 167 (even though fully depreciated), and which is not—

"(i) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of business;

"(ii) A copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in section 1221 (3); or

"(iii) Livestock held for draft, breeding, or dairy purposes, except to the extent included under subparagraph (4), or poultry.

"(2) The involuntary conversion of capital assets held for more than 6 months.

"(3) *The cutting or disposal of timber, or the disposal of coal, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.*

"(4) The sale, exchange, or involuntary conversion of livestock if the requirements of § 1.1231-2 are met.

"(5) The sale, exchange, or involuntary conversion of unharvested crops on land which is (i) used in the taxpayer's trade or business and held for more than 6 months, and (ii) sold or exchanged at the same time and to the same person. See paragraph (f) of this section.

"For purposes of section 1231, the phrase 'property used in the trade or business' means property described in this paragraph (other than property described in subparagraph (2))." (Emphasis supplied)

26 USCA § 631 (b) is a re-enactment of 1939 IRC § 117 (k) (2), with the added provision that the date of disposal of the timber shall be deemed to be the date such timber is cut.

Proposed regulations published on November 2, 1956, make even clearer provision for the capital gains treatment to be afforded timber. Reg. 1.631-2 (a) provides as follows:

"(a) *In general.* (1) If an owner disposes of timber held for more than six months before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year.

"Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e) (2) of this section for definition of 'owner'.

"(2) In the case of such a disposal, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231 (b)."

Throughout the entire history of these statutes, there has been no deviation from the clearly manifested intent of Congress that owners of timber are entitled to capital gains treatment of profits realized on sales made by them under cutting contracts wherein the owner retains an economic interest, *regardless* of whether the timber is held primarily for sale to customers in the ordinary course of business, provided the six-months holding period is satisfied.

Because of the opinion rendered in this case by the Tax Court of the United States, the Internal Revenue Service, on March 11, 1957, issued Revenue Ruling 57-90, 1957-10 I.R.B. 17, which reads:

"Section 631—*Gain or Loss in the Case of Timber or coal.*

"In the case of the disposal of timber, held for more than six months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber, pursuant to the provisions of section 631 (b) of the Internal Revenue Code of 1954, *the gain or loss on such disposal is subject to the tax treatment provided by section 1231 regardless of the nature of the taxpayer's business or the purpose for which the timber is held.* To the extent that the opinion in *Ah Pah Redwood Co. v. Commissioner*, 26 TC 1197, may be inconsistent with the foregoing, it does not represent the position of the Internal Revenue Service." (Emphasis supplied)

The Tax Court's opinion in the present case constitutes a direct contradiction of the manifest intent of Congress as expressed continually in the law itself. In addition, it directly contravenes the published regulations and rulings of the Commissioner of Internal Revenue.

Not only is appellant supported by the clearly manifested Congressional intent outlined herein, but it is entitled to rely upon the express statements published by the Commissioner of Internal Revenue in his regulations and rulings. Appellant urges that the decision of the Tax Court must be reversed.

C. The oral contract between appellant and Coast was not a disposal of timber on the date thereof under the then existing laws and regulations.

The deficiencies are based upon the theory that the profits realized by appellant in the years 1948 and 1949 from the Sage timber removed by Coast were ordinary income, the timber having been disposed of by the oral or implied agreement of 1947. The basic question presented is whether the oral or implied contract between appellant and Coast in October, 1947 (R 18), constituted a "disposal" of the timber covered by the Sage Agreement, under the provisions of Sec. 117 (k) (2) of the Internal Revenue Code of 1939. That statute provides as follows:

> "(2) In the case of the disposal of timber (held for more than six months prior to such disposal) by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber, the difference between the amount received for such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber."

In *Springfield Plywood Corporation v. Commissioner*, 15 TC 697 (1950), the taxpayer purchased timber in January, 1943, and entered into a written cutting contract in May, 1943, which was held to constitute a

"disposal" of the timber on that date. The decision turned on the court's finding that:

> "*In our view, the timber involved was all sold on May 14, 1943, and only payment, as agreed, was delayed.* However, as above seen, even without sale, in our opinion within the statute and within a reasonable and valid regulation, disposal took place on that date." (Emphasis supplied)

In the present case, there is no evidence that the timber was "disposed of" prior to the execution by appellant and Coast of their written agreement in 1950 (Exhibit 2-B; R 72). The oral agreement here may be distinguished from the written agreement in the *Springfield Plywood Corporation* case in the following particulars:

(a) The agreement did not obligate Coast to pay for timber which it did not remove.

(b) Appellant bore the fire risk through 1948 and 1949.

(c) Appellant sold 33,883,000 board feet to A. K. Wilson Lumber Co. in 1950 (R 19).

Here, the oral or implied agreement contemplated only *an oral license to cut timber as desired, with Coast required to pay only for logs removed, as removed, at a fixed price* (R 18).

In *Sorensen v. Jacobson*, 125 Mont. 148, 232 P. 2d 332, at page 335, 26 ALR 2d 1186 (1951), the Court, in speaking of a parol license to enter, cut and remove timber, said:

> "By the weight of authority such a parol or simple contract for the sale of growing timber, to be cut and removed from the land by the purchaser, is not to be construed as intended by the parties to convey any interest in land, but as an executory contract for the sale of the timber after it shall have been severed from the soil. Such a contract implies a license to enter the lands of the licensor for the purpose of severing the timber and removing the same. The severing of the trees constituted part performance of the contract, the logs becoming the personal property of the licensee. Such partly performed contract does not come within the provisions of the Statute of Frauds. (RCM 1947, § 13-606; *Stillinger v. Kelly*, 66 Mont. 441, 443, 214 P. 66; Restatement, Contracts, § 200 (c).
>
> * * * * *
>
> "It is also well settled that, while the license to enter upon the land and cut timber thereon is irrevocable as to that part of the timber which has been severed from the land, yet while the contract remains executory it is revocable at the will of the owner of the land."

In *Gullicksen v. Shadoan*, 124 Mont. 56, 218 P. 2d 714 (1950), at page 719, the Court said:

> "We have read all the cases cited herein and while the questions are not free from difficulty and

there being eminent authority to the contrary, we believe the weight of authority and the better reasoning is expressed and set forth in *Emerson v. Shores*, 95 Me. 237, 49 A. 1051, 1052, 85 Am. St. Rep. 404, being a very similar case, where the court said:

" 'It has accordingly become settled law under the decisions of this court, and by the great weight of authority elsewhere, that parol or simple contracts for the sale of growing wood or timber, to be cut and removed from the land by the purchaser, are not to be construed as intended by the parties to convey any interest in land, but as executory contracts for the sale of the timber after it shall have been severed from the soil and converted into chattel property, together with a license to enter upon the land for the purpose of cutting and removing it.

* * * * *

" '*It is equally well settled that, while the license to enter and cut timber, thus created by parol or simple contracts, is irrevocable as to that part of the timber which has been severed from the land in execution of the contract; yet, while it remains executory as to the wood or timber not yet severed from the land, it is revocable not only at the will of the owner, but by his death, or by his conveyance of the land without reservation.*'

"*Buker v. Bowden*, 83 Me. 67, 69, 21 A. 748; *Banton v. Shorey*, 77 Me. 48; *Russell v. Richards*, 10 Me. 429, 25 Am. Dec. 254; *Folsom v. Moore*, 19 Me. 252; *Brown v. Dodge*, 32 Me. 167; *Drake v. Wells*, 11 Allen 141 (93 Mass. 141). *Giles v. Simonds*, 15 Gray 441, 77 Am. Dec. 373; *Douglas v. Shumway*, 13 Gray 498; *White v. Foster*, 102 Mass. 375; *Fletcher v. Livingston*, 153 Mass. 388, 26 N.E. 1001; *Cook v. Stearns*, 11 Mass. 533; 13 Am. & Eng. Enc. Law (1st Ed.), p. 555." (Emphasis supplied)

The question then is whether an oral license to enter and cut timber constitutes a "disposal" within the terms of 1939 IRC § 117 (k) (2).

A license in real property may be defined as a personal, unassignable and ordinarily revocable privilege which may be created by parol to do one or more acts on the land without possessing any interest therein. A license is an authority to do a lawful act which without it would be unlawful, and while it remains unrevoked, a license justifies the acts which it authorizes to be done. This is true even of a bare parol license given without consideration. 33 Am. Jur. 398 (Licenses § 91).

A case similar on its facts is *Anderson v. Moothart*, 198 Or. 354, at page 357, 256 P. 2d 257 (1953). In that case the Court said:

> "The agreement between the parties in this suit was oral, but, whether written or oral, the result would be the same, for the defendants were not purchasing the timber as it stood but only as it was severed from the real property and became personalty, to be paid for at the rate of $2.00, and then later $3.50 per one thousand board feet *as scaled*. *Coquille Mill & Tug Co. v. Robert Dollar Company*, 132 Or. 453, 469, 285 P. 244. Such an agreement creates only a license to enter upon the lands of the licensor for the purpose of cutting and removing the timber. *Coquille Mill & Tug Co. v. Robert Dollar Company*, supra; *Elliott v. Bloyd*, 40 Or. 326, 67 P. 202; *Sorensen v. Jacobsen*, (Mont.) 232 P. 2d 332.

> And while the agreement remains executory it is revocable at any time at the will of the licensor, unless such valuable and permanent improvements had been made in reliance thereon that it would amount to the perpetration of a fraud if the license were revoked. 1 Thompson on Real Property, Perm. Ed., § 115, p. 163; *Beckman v. Brickley*, 144 Wash. 558, 258 P. 488; *David v. Brokaw*, 121 Or. 591, 256 P. 186." (Emphasis supplied)

The rule with regard to parol licenses is the same in California. *Broads v. Mead*, 159 Cal. 765, 116 Pac. 46 (1911).

In the case of *Bomberger v. McKelvey*, 35 Cal. 2d 607, 220 P. 2d 729, at page 736, the California Supreme Court said:

> "A mere license to enter or use premises may be revoked at any time by the licensor. See *County of Alameda v. Ross*, 32 Cal. App. 2d 135, 143, 89 P. 2d 460; 16 Cal. Jur. 285; 33 Am. Jur. 404."

The authorities are uniform in stating that an oral license to enter, cut and remove timber, is revocable by the grantor at any time as to timber remaining uncut. Therefore, there *cannot* be a "disposal" of the timber at the time the license is granted, insofar as 1939 IRC § 117 (k) (2) is concerned.

Appellant having granted a parol license, there is no "disposal" until such time as the licensee has actu-

ally cut and removed the timber from the property. Appellant is entitled to long-term capital gains treatment of the profits arising from timber removed by Coast from the Sage tract at any time subsequent to April, 1948. The decision of the Tax Court must be reversed and remanded, with directions to accept appellant's returns as correctly reporting the income received from Coast during 1948 and 1949 as long term capital gains.

II.

THE TAX COURT ERRED IN ITS DETERMINATION THAT APPELLANT'S DEPLETION ALLOWANCE FOR THE TAXABLE YEARS 1948 AND 1949 IS NOT ADJUSTABLE TO CORRECTLY REFLECT THE UNITS OF TIMBER STANDING ON APPELLANT'S PROPERTY DURING THOSE YEARS.

A. The depletion allowance for 1948 and 1949 is adjustable because of gross error, misrepresentation or fraud.

The statute in effect during the years in question was Sec. 23 (m) of the Internal Revenue Code of 1939. That section provides as follows:

> "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each

case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate."

The applicable regulation was Reg. 111, § 29.23 (m) -22. It provided:

"*Revaluation of timber not allowed.* No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, *except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made.* Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit should be changed when a revision of the remaining number of units of recoverable timber in the property has been made in accordance with section 29.23 (m) -26."

The statute and regulation are clear; a revision of the basis for depletion will be allowed only when mis-

representation or fraud or gross error exists with regard to facts known on the date the valuation was made.

The record discloses that when the depletion unit of $3.941566 per thousand board feet was computed, both appellant and respondent believed that the amount of timber on the Sage Tract was that shown on Schedule A of Exhibit 1-A (R 18-19). The depletion allowance was computed on this figure.

According to Witness Adkins (R 41), the actual amount of timber remaining on the Sage lands in the fall of 1954 was 37 million board feet. If the amount of timber shown by Schedule A of Exhibit 1-A had been correct, there should have been remaining 220 million board feet. Since the total amount of timber on the lands according to Exhibit 1-A was originally 382 million board feet, there was therefore an underrun of approximately 48 per cent.

The Tax Court failed to distinguish between adjustment of the depletion deduction in years subsequent to the year of discovery of an error in the amount of timber present on the tract and revaluation of the depletion basis as of the date of the acquisition of the timber with resulting adjustments of depletion deductions in all open years subsequent to the date of acquisition. Appellant seeks the latter, basing its claim upon misrepresen-

tation, fraud or gross error as provided by statute and established by the record. A falldown of 48 per cent must and clearly does constitute misrepresentation or fraud or gross error, or possibly all three, within the meaning of the statute.

In *Rust-Owen Lumber Co. v. Commissioner*, 74 Fed. 2d 18 (7th Cir., 1934), the court considered the problem of depletion basis to be permitted to a taxpayer with regard to cutting of timber. In determining that the taxpayer should be permitted to revalue its timber as of the original date of valuation, and should be allowed to claim increased depletion allowances, the court said (at page 21):

> "The Commissioner contends that when subsequent operations disclosed an increase in quantity of timber it was his duty to correct the quantity of reserve to reflect the increase, in order to correctly determine the percentage of annual depletion so that the recovery of the entire capital might coincide with the conclusion of the cutting. This is quite true, but he further insists that it was also his duty, at the same time, to revise the unit value, or the value per thousand feet of the timber. In this we think the Commissioner is in error. *His conclusion in this respect could be true only in case the amount of capital investment were based on cost, rather than actual value.* We hold that petitioner's capital investment must be the entire actual footage of the pine at the rate of $14 per thousand feet, plus the entire actual footage of the other timber at the rate of $4 per thousand feet. It is true that article 230 of the Treasury Regulations provides that the unit

market value of timber will subsequently be changed if from any cause such unit market value if continued as a basis of depletion shall, upon evidence satisfactory to the Commissioner, be found inadequate or excessive for the extinguishment of the fair market value as of March 1, 1913. With that regulation, reasonably used for the purposes of carrying out the provisions of the statute, we have no complaint, *but it can not be used to limit the rights plainly granted by the statute* (*Morrill v. Jones*, 106 U.S. 466, 1 S. Ct. 423, 27 L. Ed. 267), even though the statute be re-enacted after the promulgation of the regulation.

* * * * *

"It is contended by the Commissioner, however, that even though the estimate of the quantity of timber on March 1, 1913 was less than the actual amount, the remaining reserve can not be corrected and the unexhausted value apportioned to the corrected quantity, thus obtaining revised depletion rates, because under the treasury regulations, the timber reserve may not be revalued during the same ownership except for fraud, misrepresentation, or gross error. In this case the ownership remained the same and it is admitted that there was neither fraud nor misrepresentation; but that there was gross error in estimating the timber reserve as of 1913, is alleged by petitioner and denied by the Commissioner.

"The final cut of the timber disclosed that there was gross error in prior estimates of the timber reserve. The overrun amounted to more than 45,000,000 feet, which at its actual value would increase the capital investment by more than $300,000, and if reflected in the depletion account would increase petitioner's total depletion deductions for

> 1927, 1928 and 1929, over those allowed by the Commissioner, by almost $260,000. The tax involved is more than $36,000. These figures seem to us to be more than trivial in their import and convince us that there was gross error in the prior estimates within the meaning of the Statute and the treasury regulations."

Certainly the term "gross error" should apply to a transaction wherein the appellant acquired only half of what it bargained for. That there existed a misrepresentation of material fact cannot be questioned. It is equally apparent that the so-called "underrun" did exist during the years in question.

Appellant's returns for the years 1948 and 1949 are open for review by virtue of this proceeding, and the Tax Court has the power and the duty to determine the deficiency, if any, of appellant. The adjustment to appellant's depletion basis and depletion allowance for the years 1948 and 1949 should be allowed. The decision must be reversed and remanded with directions to recompute the depletion basis and therefore the depletion allowances of appellant for the years in question.

CONCLUSION

Appellant, throughout the years in question, used the Sage timber in a manner normal and customary for timber and logging companies. Having acquired the timber, it licensed Coast to remove it, at such time and in such amounts as the licensee might desire. The price to be paid for the timber, when and if removed, was fixed and certain. Appellant's returns reflected this method of operation. It reported as long-term capital gains the profits realized on the timber removed during the years in question.

The evidence in the case is undisputed and clear. The timber was sold from time to time as cut. All timber held by appellant for more than six months prior to sale is entitled to long-term capital gains treatment under the provisions of 1939 IRC Sec. 117 (k) (2).

The authorities presented clearly support appellant's contention and further establish that appellant is entitled to recomputation and adjustment of its depletion basis and depletion allowance. The refusal of the Tax Court to allow such recomputation is arbitrary and without basis in law.

To permit the decision of the Tax Court to stand will jeopardize the business methods developed by timber

owners since the first enactment of 26 USCA Sec. 631 (1939 IRC Sec. 117 (k)). Timber owners will be forced to sacrifice established methods of operation in order to reduce their vulnerability to similar rulings made upon issues not raised before the Tax Court.

The record of this case, and the authorities cited herein, make imperative an express ruling that an owner of timber otherwise complying with IRC Sec. 631 is entitled to capital gains treatment on timber sold *regardless* of the nature of his business or the purpose for which the timber is held.

The Commissioner of Internal Revenue by his ruling of March 11, 1957 (Rev. Rul. 57-90, 1957-10 I.R.B. 17) specifically granted relief to all other timber owners. Appellant's relief under the ruling must come from this court.

Appellant is entitled to a decision directing the acceptance of appellant's returns for 1948 and 1949 as filed insofar as they report amounts received from Coast as long-term capital gains. Furthermore, the Court must direct that the depletion basis of the Sage timber be revalued as of the date of its acquisition by appellant, and, based upon such revaluation, must further direct

the adjustment of appellant's depletion allowance for the years 1948 and 1949.

Appellant is clearly entitled to the relief it seeks. The judgment of the Tax Court of the United States must be reversed.

Respectfully submitted,

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APPENDIX

1. 26 USCA § 7453.—Rules of practice, procedure, and evidence.

"The proceedings of the Tax Court and its divisions shall be conducted in accordance with such rules of practice and procedure (other than rules of evidence) as the Tax Court may prescribe and in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia. Aug. 16, 1954, 9:45 a.m., E.D.T., c. 736, 68A Stat. 884."

2. Tax Court Rule 31. Evidence and the submission of evidence. (a) Rules applicable.—"The proceedings of the Court and its Divisions will be conducted in accordance with the rules of evidence applicable in trials without a jury in the United States District Court for the District of Columbia."

3. Rule 52 (a)—Federal Rules of Civil Procedure:

"*Effect.* In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the appropriate judgment; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or

56 or any other motion except as provided in Rule 41 (b). As amended Dec. 27, 1946, effective March 19, 1948."

4. 1944 C.B. 993, 1015 read as follows:

"If the taxpayer so elects upon his return, the cutting of timber during the year by the taxpayer who owns or has a contract right to cut such timber is treated as a sale or exchange of the timber cut during the year and such cut timber is considered property used in a trade or business of the taxpayer for the purpose of section 117 (j) of the Internal Revenue Code provided the taxpayer has owned such timber or held such contract right for a period of more than six months prior to the beginning of such year. Where such an election is made, gain or loss to the taxpayer is recognized in an amount equal to the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer and the fair market value of such timber. The fair market value is determined as of the first day of the taxable year in which the timber is cut.

"The election which is made is binding on the taxpayer with respect to all timber which he owns or which he has a contract right to cut and is also made binding for all subsequent years unless the Commissioner, upon the showing of undue hardship, permits the taxpayer to revoke his election.

"If an owner of timber disposes of it under a contract by virtue of which he retains an economic interest in such timber, the amount received by such owner is to be treated in a similar manner."

* * * * *

"Under section 117 (k) (2) as added by this section, in the case of timber which has been disposed of by the owner, who has held it for more than six months prior to such disposal, under any form or type of contract by virtue of which the owner retains an economic

interest in such timber, the difference between the amount received for such timber and the adjusted basis for depletion of such timber in the hands of the owner, shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber. *Such timber shall be considered 'property used in the trade or business' of the owner within the meaning, and for the purposes, of Section 117 (j).*

"Subsection (b) of this section amends section 117 (j) (1) of the Code by including within the definition of 'property used in the trade or business,' timber as provided in section 117 (k). Thus gain or loss arising from the cutting of timber with respect to which an election has been made under section 117 (k) (1), and from timber which has been disposed of, as provided in section 117 (k) (2), shall be considered, or shall not be considered, as gains or losses from the sales or exchanges of capital assets under the provisions of section 117 (j), depending upon the operation of such section in the case of the taxpayer." (Emphasis supplied)

5. 1944 C.B. 1059, 1068 reads as follows:

"Under section 117 (k) (2), as added by this amendment, if a taxpayer who has owned timber for more than six months disposes of such timber under any form or type of contract by virtue of which the owner retains an economic interest in such timber, the difference between the amount received for such timber and the adjusted basis for depletion of such timber in the hands of the owner shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber. *Such timber shall be considered 'property used in the trade or business' of the owner for the purposes of section 117 (j).*

"*Section 117 (j) (1) of the Code is amended by including within the definition of 'property used in the trade or business', timber as provided in section 117 (k).*" (Emphasis supplied)